EXECUTIVE SECRETARIAT

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Remarks

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Executive Secretary

2 Oct '86

Date

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Executive Registry
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THE WHITE HOUSE

WASHINGTON

October 1, 1986

MEMORANDUM FOR THE ECONOMIC POLICY COUNCIL

FROM: EUGENE J. McALLISTER EM

SUBJECT: Agenda and Paper for the October 2 Meeting

The agenda and paper for the October 2 meeting of the Economic Policy Council are attached. The meeting is scheduled for 4:00 p.m. in the Roosevelt Room.

The first agenda item will be a discussion of the current status of the Section 301 case against Brazil's informatics policy. A paper prepared by the TPRG on possible options in this case is attached.

The second agenda item will be a report on the status of the Japanese tobacco 301 case. There will be no paper for this item.

Confidential attachment

ECONOMIC POLICY COUNCIL

October 2, 1986

4:00 p.m.

Roosevelt Room

AGENDA

1. Brazil Informatics
2. Japan Tobacco

September 30, 1986

MEMORANDUM FOR THE ECONOMIC POLICY COUNCIL

From: Trade Policy Review Group

Subject: Brazilian Informatics Section 301

ISSUE

On May 14, 1986, the EPC informally agreed that the Brazilian informatics restrictions represent an "unreasonable" trading practice under section 301 and directed the TPRG to begin preparing a retaliatory package. The EPC further agreed that it would recommend that the President make a formal finding of unreasonableness under section 301, unless the Brazilians entered into "serious negotiations" to resolve the informatics dispute. The EPC must now review the results of the bilateral consultations with the Brazilians and determine an appropriate USG response in preparation for USTR's October recommendation to the President.

BACKGROUND

Section 301 Case

- This informatics case is one of three that were self-initiated by the Administration last September. USTR provided a recommendation to the President regarding an unreasonableness finding on September 15 and promised an appropriate course of action within 21 days (i.e., by October 6).

Brazilian Informatics Policy

- The informatics investigation challenges a Brazilian law and policies that severely restrict U.S. trade and investment in the informatics sector and withhold explicit copyright protection for computer software.

- These policies have resulted in a rapid and unchecked proliferation of restrictions on U.S. informatics products. A comparative market analysis prepared by the U.S. Department of Commerce and approved by an inter-agency working group estimates that U.S. companies are losing between $337 and $452 million in sales of hardware and software per year as a result of the Brazilian restrictions.

EPC Decision

- In February, the GOB agreed to meet with the USG in Caracas. The talks were polite, but unproductive.

- On May 14, the EPC informally agreed that the Brazilian informatics regime is a violation of section 301 and directed the TPRG to develop a package of retaliatory options. The EPC further agreed to recommend that the President issue a formal finding of unreasonableness, unless the Brazilians entered into "serious negotiations" within a "reasonable period of time."

- Informatics is a highly nationalistic issue in Brazil and the section 301 case is often perceived as an attack on Brazilian national sovereignty. Reports of the EPC's decision led to a series of inflammatory newspaper articles in Brazil and a negative public reaction.

- On May 26, Deputy Secretary of State Whitehead visited Brasilia. The Whitehead visit succeeded in calming the Brazilians and produced an agreement to begin bilateral consultations. (The Brazilians had previously refused to negotiate.)

- On July 2, USTR Yeutter and Brazilian Special Ambassador Paulo Tarso Flecha da Lima held bilateral consultations in Paris. Although the GOB delegation was cordial, it made no concessions. However, the Brazilians indicated that the Sarney Administration has "no present intention" of applying the market reserve policy to other sectors, such as pharmaceuticals, or extending the policy as it relates to trade after its scheduled expiration date in 1992. Apart from these clarifications, the Brazilians firmly defended the informatics law.

- The third round of consultations on August 11 focussed on a non-paper listing USG objectives in the section 301 case. The Brazilians were polite but showed very little flexibility. They indicated that the GOB is weighing possible forms of intellectual property protection for computer software and offered to communicate the results of their internal deliberations to the USG. They also offered to establish an ad hoc government appeals group to review problems encountered by U.S. companies on a case-by-case basis.

- On August 12, Ambassador Yeutter delivered a letter to Ambassador Paulo Tarso which outlined objectives in the areas of market reserve, administrative procedures, investment and intellectual property rights. On September 3, the GOB submitted its written response, which largely reiterated concessions already discussed during the two previous rounds of consultations. Certain proposals were actually weakened in the written version. Most of the concessions were vaguely-worded commitments for future action. As in the Paris talks, the most prominent omission was in the investment area.

o On September 20, Ambassador Yeutter met in Rio de Janeiro with Ambassador Paulo Tarso in an effort to clarify the GOB "offer" and to determine if improvements were possible. The GOB refused to make substantive improvements but rather focussed its presentation on recent cases (i.e., SEI approvals of two IBM investment projects) in which it had favored foreign investors. It is not clear whether further progress can be made at this time.

Progress of Negotiations

Our assessment of Brazil's offer is as follows:

o Market Reserve - The production of informatics products is limited to Brazilian national companies through a policy known as "market reserve." The effect of market reserve is to prohibit foreign trade and investment in certain segments of the Brazilian market. The USG has asked for a commitment not to renew market reserve for informatics after 1992, a phase-out of market reserve for certain informatics products, and an agreed definition of "informatics" products to limit the vague and expansive interpretation by SEI.

Status: The Brazilians' letter indicated that the Sarney Administration has no intention of renewing market reserve for informatics after it expires in 1992 or of extending market reserve to new sectors. They have clarified, however, that Sarney is not in a position to bind future Brazilian presidents or the Brazilian Congress. In addition, even without "formal" market reserve, Brazil uses other trade and investment measures to restrict its market. The Brazilians have also indicated that their all-encompassing interpretation of "informatics" products, e.g. toy animals containing a computer chip, is deliberate and fully consistent with the spirit of the law. Discussions with the GOB have indicated that it would be willing to work on providing the USG with a list of traded products excluded from the definition of "informatics." However, with limited exceptions, this list would probably be updated each year, significantly diminishing the list's usefulness in establishing certainty for U.S. industry.

o Investment - Brazil restricts new U.S. investment in the informatics sector and limits the expansion, upgrading, and modernization of existing production facilities. The USG has asked for national treatment for U.S. firms, a right to upgrade existing facilities without government interference, and implementation of provisions of the informatics law allowing 30 percent foreign ownership of joint ventures and 100 percent foreign ownership in exceptional circumstances. The U.S. would also like to see some limits on Brazilian export performance and local content requirements.

Status: The Brazilians deny that U.S. firms face investment restrictions and have offered no assurances that they will permit even the limited joint ventures provided for in the law. Nor is there a provision for the termination of market reserve as it relates to investment. Moreover, it is not clear whether the new CONIN appeals process applies to investment, as well as import, decisions; nor is it apparent how SEI's modernization will assist the investment approval process. While the GOB has pointed to its recent approval of two IBM projects (including one for mainframe disks) as proof of the open investment climate in Brazil, it has not abandoned its case-by-case, close scrutiny approach and the restrictions on foreign equity ownership that act as serious deterrents to foreign investment.

- Administrative Procedures - U.S. companies have complained about burdensome and opaque Brazilian administrative procedures. The USG has asked for time limits, clear criteria for evaluating applications, and a right of appeal.

  Status: The GOB's letter and subsequent discussions propose (1) CONIN as an appeals board for companies contesting SEI decisions; (2) "modernization" of SEI's administrative procedures; (3) establishment of ad hoc committees within the U.S.-Brazil Trade Subgroup "to survey special issues of concern to our bilateral economic relationship;" and (4) adoption of "indicative" schedules for decisions related to imports and investments. While some of these proposals appear to be responsive to Ambassador Yeutter's requests, the proposals are not sufficiently detailed to allow an assessment. The GOB response did not offer to provide definitive criteria for SEI's approval of import licenses nor to specify time limits for reviewing applications.

- Computer Software - The USG is seeking full copyright protection for computer software, i.e. life of the author plus 50 years, as well as a commitment by the GOB to refrain from a proposed decree that would require the registration of all imported software and restrict the importation of any software with a Brazilian national "similar."

Status: The GOB informed us that CONIN has recommended that copyright be adopted for software. We know from President Sarney's recent discussion with Ambassador Shlaudeman that the GOB believes 25 years' protection would be sufficient, although this detail is omitted from its letter. During the September 20 meeting, the GOB said it had been consulting closely with the French (who have adopted a 25-year rule) and that "Brazil's law will follow the principles of the copyright convention." We have no assurance that the Congress will approve the President's legislation once submitted. Absent from the letter are responses to our request to (1) review the draft software intellectual property rights protection proposal before it is submitted to the Brazilian legislature; (2) improve enforcement of intellectual property rights, including trade secret protection; and (3) not extend market reserve to software. With respect to the last point, President Sarney recently rescinded regulations that would have imposed new restrictions on software commercialization.

U.S. Industry

o The U.S. industry has taken a cautious approach to the case, since several companies have major investments in Brazil which could be the targets of counter-retaliation. Consequently, the case has been driven by the USG's concerns about the implications of Brazilian policies for future bilateral trade relations and the spread of market reserve to other sectors in Brazil as well as to other developing countries.

o Some in the industry have indicated that the USG should proceed with retaliation if necessary, since abandoning the case now could encourage further proliferation of restrictions on U.S. products in Brazil and other developing countries. Others, however, expressed a strong preference for avoiding retaliation, since a trade war could jeopardize their investments. A few have suggested that Brazil's continued uncertainty regarding the USG's ultimate intentions has resulted in improved SEI treatment of foreign investors.

o When approached on a possible interim deal, the industry was adamant that computer software receive full (life plus 50 years) copyright protection. Industry representatives stated that the companies would support an interim package that included copyright protection, no software registration requirements, a list of excluded products, and GATT notification.

Congressional Views

- o In general, Congress has not played an active role in the development and pursuit of this section 301 case. Because of the U.S. informatics industry's ambivalence about the case, there has been no pressure for Members to become active participants in the issue.

- o However, should Brazil refuse to grant further concessions and should we refrain from retaliating, we should expect serious opposition from those in Congress who believe that the Administration lacks resolve in trade policy and section 301 in general. Those who wish to eliminate Presidential discretion in section 301 and other statutes may use our unwillingness to take strong action against Brazil as an argument to press for amendments limiting the President's discretion. In addition, those who seek retaliation against Brazil for constituent reasons, e.g. representatives of footwear-producing states, will criticize the lack of action.

Brazilian Debt

- o Brazil is unlikely to undertake broad, precipitous action with respect to its debt service (i.e. a moratorium) but its level of rhetoric is likely to increase, even though this could hurt Brazil by undermining financial market confidence. The GOB may also continue to refuse to eliminate $2 billion in arrears of official credit, including $300 million to Eximbank.

GATT Implications

- o Since the beginning of the section 301 case, there has been inter-agency agreement that the informatics issue should not be pursued in GATT. First, several important elements of the case, such as investment and intellectual property, are not subject to current GATT disciplines. Second, it is doubtful that Brazil would cooperate in a GATT dispute settlement proceeding and even more unlikely that Brazil would accept an adverse panel ruling.

- o Nevertheless, several elements of the informatics policy raise serious GATT questions, such as the market reserve and law of similars. These issues were raised briefly in Brazil's 1985 GATT Balance-of-Payments (BOP) Committee review. Brazil, however, took an unhelpful approach to the BOP review. Brazil may receive support for its restrictions from other developing countries who also use BOP measures to restrict imports and protect domestic industries. In the September bilateral meeting, the GOB indicated that, contrary to USG requests, it had no intention of notifying its policy to the GATT.

Options

On September 15, the USTR recommended to the President that he determine that Brazil's informatics policies and practices are unreasonable within the meaning of Section 301 of the Trade Act of 1974. The USTR also recommended that the President refrain from issuing the determination or making a decision on possible U.S. responses until October 6, 1986, the statutory deadline. This delay would allow further time for negotiations, which took place on September 20. The EPC must now determine what actions the USTR should recommend that the President take on October 6.

Option 1: USTR recommends that the President announce his intention to retaliate against Brazilian exports under Section 301. Retaliation would take place after public comment on potential retaliatory measures has been received and evaluated by the TPRG.

Advantages

- Demonstrates to GOB that market reserve and other protectionist trade and investment policies are not without cost.

- Preserves USG credibility for future negotiations. Lays down marker for planned consultations regarding GOB's policies for pharmaceuticals/fine chemicals and proposed talks on *de facto* or planned market reserve for biotechnology, motion pictures, freight forwarders and strategic minerals.

- Time required to develop appropriate actions, obtain public comment and agree internally on measures would provide GOB an opportunity to offer further concessions *after* its November elections and before USG actually retaliates.

- Could over long term lead to eventual solution to informatics. Past experience indicates that the GOB responds only to pressure and that, after an initial outcry, Brazil will look for ways to resolve the problem.

- Could serve as a deterrent to other LDCs contemplating restrictions on U.S. high-tech exports and investment. A number of NICs and LDCs in South America and elsewhere have begun to copy Brazil's market reserve policy in computers and other sectors. Korea is following this case closely.

- Demonstrates Administration's forcefulness in countering unfair trade practices; preserves integrity of 301 process.

- By demonstrating Administration resolve, helps to counter legislation to remove the President's discretion under Sections 201 and 301.

- May give Brazilian groups who oppose informatics policy greater leverage with GOB and resolve to press for solution to this issue.

Disadvantages

- By antagonizing the GOB, encourages further deterioration in U.S.-Brazil economic relations. Informatics is a highly emotional, nationalistic issue in Brazil and any U.S. action is likely to result in a strong reaction from the GOB and the Brazilian public.

- This option may provoke Brazilian counter-retaliation against U.S. exports to or investments in Brazil. In particular, retaliation could threaten the interests of U.S. computer firms operating in Brazil and those attempting to do so.

- Likely to emerge as issue in Brazil's November elections and could adversely affect work on new Brazilian constitution.

- There is no guarantee that retaliation will induce the GOB to enter into negotiations.

- Could embarrass President Sarney, coming so soon after his State visit to Washington on September 10.

- Since retaliatory measures would involve restrictions on Brazilian trade with the U.S. and could violate the GATT, the GOB might pursue a GATT dispute settlement case.

- Most U.S. informatics firms oppose retaliation until all negotiating possibilities have been exhausted.

Option 2: USTR recommends that the President announce continuation of the Section 301 case while the USG 1) monitors implementation of concessions already offered, and 2) presses for additional concessions. A final Presidential determination will be made:

(i) on December 15, 1986, or

(ii) no later than 120 days after October 6, 1986.

USTR also recommends that the President announce that we will during the above timeframe:

A) Request public comment on appropriate retaliatory action. (The TPSC would develop options for action. A Federal Register notice would be published following the Brazilian elections and comments would be solicited from the private sector, including ISACs, and other interested parties. The TPRG would submit a final recommendation of proposed retaliatory action to the EPC for decision.)

and/or

B) Suspend U.S. tariff concessions under GATT Article XVIII(21) on imports from Brazil whose trade is equivalent to the annual loss in U.S. sales opportunities in Brazil due to the informatics policy. This action would be notified to the GATT. (An illustrative list of products that could be drawn on for this action is attached.)

Advantages

- Creates uncertainty in Brazil regarding future USG action, which tactically may result in further GOB concessions.

- Would demonstrate seriousness of USG resolve without actually affecting trade flows. GOB could not claim its trade interests had been harmed and would have a difficult time bringing a successful case in the GATT, since U.S. action under option 2(B) could be defended under Article XVIII.

- Could be used as first stage in gradually increasing pressure, which would give the USG more flexible negotiating leverage. Since GOB often responds only to pressure, it might offer additional concessions to avoid further action.

- Option 2(B) Could lead Brazil to a GATT appeal to protect its trade interests, thereby forcing Brazil to defend its market reserve policy in GATT, perhaps under the infant industry or balance of payments provisions. Such a scenario could assist in USG attempts to strengthen the functioning of temporary measures provisions under GATT.

- Option 2(A) would enable the Administration to delay calling for public hearings until after the Brazilian elections, thereby avoiding a serious public reaction in Brazil during this politically-charged time.

Disadvantages

- Message to GOB and other countries considering market reserve policies would not be as strong as in option 1.

- Suspension of GATT tariff concessions under Option 2(B) may be too subtle an action to force further GOB concessions, yet may still provoke a strong public reaction in Brazil.

- Suspension of GATT tariff concessions under Option 2(B) may be viewed by U.S. Congress and GOB as merely shifting a difficult 301 to the GATT.

- o GOB may defend informatics policy under national security provision of GATT.

- o No guarantee that these actions will induce the GOB to continue negotiations or to defend its policies in GATT.

- o Could serve as GOB pretext to postpone further concessions, and could lead to pressures by other GATT CPs to delay any USG action under 301 process until GATT review is completed.

- o Some firms adversely affected by trade uncertainties created by suspension of tariff concessions will be U.S.-based exporters from Brazil.

Option 3: USTR recommends that the President announce continuation of the Section 301 case while the USG 1) monitors implementation of concessions already offered, and 2) presses for additional concessions. A final Presidential determination will be made:

(i) December 15, 1986, or

(ii) no later than 120 days from October 6, 1986.

Advantages

- o Eases friction in U.S.-Brazil bilateral relations.

- o Allows USG more time to negotiate resolution of case, while maintaining President's flexibility to take action in the event GOB continues to reject further concessions.

- o Allows President Sarney more time to develop internal support for further concessions and for Brazilian public opinion to cool without the domestic political pressure that surrounds Brazil's November 15 elections.

- o Avoids embarrassing President Sarney so soon after his State visit to Washington.

- o Some U.S. companies favor deferral since it "keeps the pressure" on the GOB to act favorably toward U.S. import and investment requests in Brazil.

- o Some U.S. companies favor deferral of U.S. action if the GOB agrees to 1) allow upgrading of existing investment, 2) notify GATT, 3) provide list of products excluded from market reserve, 4) full copyright protection for software (50 years), and 5) commit not to implement software commercialization regulations.

Disadvantages

- Could eliminate GOB's incentives to offer adequate concessions, particularly since it often responds only to increased pressure. GOB may perceive delay as indication that USG is backing away from objectives or resolve to take action in event case is unsettled, particularly since no retaliatory action is specified deadline for resolution. This perception may be more likely since USG has postponed previous internal "deadlines" for decisions (i.e., April 15 and July 15).

- Delay is based to large extent on assumption that President Sarney is willing to make substantive concessions, but that current domestic political environment prevents him from doing so. USG has no indication that adequate concessions would be forthcoming, even if more time were allowed.

- Case may be as difficult to negotiate with GOB after Brazilian elections as before. Newly-elected legislature will be writing Brazil's constitution, and the market reserve for informatics or other sectors may be included regardless of which party obtains majority.

- Deferral of action may encourage hardliners in new Brazilian Congress to extend market reserve to other sectors, since they believe they can "get away with it."

- Not taking action on 301 case within 12-month time period may stimulate more U.S. industry and U.S. Congressional attention than taking action. May be perceived as indication of Administration's lack of resolve to counter unfair trade practices.

- Could be used by U.S. Congress as reason to curtail President's discretionary authority under Sections 201 and 301.

- Other interested countries (e.g., Korea) may perceive delay as indication that USG is not serious about pursuing 301 action.

- May weaken credibility of USG negotiating leverage for upcoming consultations with Brazil on pharmaceuticals/fine chemicals and proposed talks on motion pictures/intellectual property rights.

[illegible] STAFF LEVEL

NEW – NO INTERAGENCY CONSIDERATION YET

DISPUTED – DOC STAFF LIKE; SOME AGENCY OPPOSITION

ADDITIONAL – MOST CONTROVERSIAL; MAY REQUIRE PARTIAL RETALIATION e.g., TARIFF SURCHARGE OR QUOTA

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TABLE 3

Brazil Informatics 301
BACKGROUND DATA ON NON-AGRICULTURAL CANDIDATES FOR RETALIATION
(Millions of Dollars)

Product Name	US Imports fr. Brazil 1985	83-85	CAGR	Item % Total BR XP	US MP	Brazilian Industry	U.S. Industry
Consensus Products	$128.4	$110.4					
Benzene	$ 21.4	$ 29.2	-12%	95%	11%	Petroquina (GOB)	Excess capacity
Wood Furniture	$ 18.2	$ 11.0	85%	50%	2%	Indigenous; Sao Paulo & South; small firms	Views as import-sensitive
Ceramic Tiles	$ 14.3	$ 10.9	40%	NA	6%	Indigenous; South & Southeast; major employer	Views as import-sensitive
Pistols & Revolvers	$ 8.9	$ 4.5	144%	NA	24%	Indigenous; Rio Grande do Sul	Approached USG
Informatics	$ 65.6	$ 54.8	21%	16%	1%	U.S. and foreign subs; 90 national firms	Subject of 301
						only Brazilian firms; retaliatory value estimated at only $12 million	
New Products	$ 87.0	$ 61.1					
Ferrosilicon	$ 20.6	$ 19.2	10%	27%	26%	Mostly indig. (no U.S. invst.); Sao Paulo, Bahia	Approached USG
Earthenware	$ 16.5	$ 12.8	44%	72%	2%	NA	Views as import-sensitive
Ceramic Sanitary Ware	$ 15.7	$ 6.8	321%	62%	32%	Indigenous; export-oriented trade association	Views as import-sensitive
Silicon	$ 13.9	$ 7.5	58%	NA	30%	NA	Views as import-sensitive
* Herbicides	$ 11.0	$ 5.5	701%	NA	9%	Nat'l. firms, for. subs; U.S. MNCs may export	Have IPR concerns
Leather Handbags	$ 9.3	$ 9.3	1%	50%	5%	Indigenous	Views as import-sensitive
Disputed Products	$216.3	$160.8					
Men's Footwear	$125.9	$106.4	32%	90%	6%*	Indigenous; Sao Paulo	Approached USG
* Paper Machinery & Pts.	$ 36.3	$ 13.2	1000%	27%	17%	U.S. and foreign (FRG) subs; Sao Paulo	Beloit; others complain
Hardboard	$ 25.4	$ 25.4	2%	60%	45%	Indigenous; Sao Paulo; strong trade association	Excess capacity
Machine Tools, M-Wkg.	$ 22.3	$ 10.2	152%	21%	2%	Indigenous and foreign sub (FRG)	Views as import-sensitive
Selected Textiles	$ 6.4	$ 5.6	78%	NA	NA	Indigenous	Views as import-sensitive
Additional Proposals	$1693.9	$1530.7					
Women's Footwear	$797.5	$685.6	30%	91%	48%	Indigenous; South	Approached USG
Motor Fuel	$692.0	$663.1	10%	50%	1%	Petrobras (GOB)	Excess refining capacity
Tin	$129.5	$110.1	34%	74%	32%	Indigenous	No U.S. production
Passenger Cars						Nat'l. firms and foreign subs; VW do Brasil	VW of America would object
Textiles, MFA-growth	$ 74.9	$ 71.9	21%	NA	NA	Indigenous; U.S. subs not exporting to U.S.	Views as import-sensitive

Data are based on U.S. imports for consumption, c.i.f.
KEY: 83-85 = average value; CAGR = compound annual growth rate, 1983-85; BR XP = Brazilian Exports; US MP = U.S. imports
* Imports from Brazil as a percent of U.S. consumption
NA Not available

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